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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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William F. Caton, Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

In re Matter of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, **CC Docket No. 96-128**

Dear Mr. Caton:

Enclosed for filing in this docket are the original and one copy of a white paper on the reassignment of RBOC payphone assets. This white paper was provided at the request of the staff. I would ask that you include it in the record of this proceeding.

If you have any questions concerning this matter, please contact me at (202) 326-7902.

Thank you for your consideration.

Yours sincerely,

Michael K. Kellogg

Michael K. Kellogg

Enclosures

cc: K. Ackerman, M. Carowitz, R. Crellin, P. DeGraba, T. Machcinski, E. Maxwell, J. Muleta, G. Reynolds, M. Richards, G. Rosston, R. Spangler, T. Zagorsky, R. Baca, D. Gonzalez, K. Gulick, J. Nakahata

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Reassignment of RBOC Payphone Assets

The RBOC Payphone Coalition submits this white paper to respond to various asset reassignment questions raised by members of the Commission staff, as well as some arguments raised by other participants in ex parte communications. Specifically, the Coalition will address the contention that payphone assets should be reassigned at "going concern value" to the extent this exceeds net book value.

The basic premise of the "going concern" approach seems to be that there has been an appreciation in the value of payphone assets, and that any such appreciation must be allocated to ratepayers. In substance, shareholders would be required to "purchase" the business (through rate reductions) at an appreciated "going concern value."

This basic premise is fatally flawed. As an initial matter, none of the payphone assets on RBOC books -- and thus none of the payphone assets on which ratepayers have paid RBOCs a return -- have appreciated in value. Instead, any "gain" from using "going concern value" comes from valuing intangibles (such as location owner contracts, the RBOC name, and goodwill) that have never been on the RBOC books and have never been a source of regulated compensation. Nothing in the Telecommunications Act of 1996, no judicial decision, and nothing in the Commission's rules authorizes the Commission to allocate to ratepayers a gain on intangible assets that are outside the rate base. In fact, any such allocation would be highly inequitable and unlawful, as shareholders, not ratepayers, bore the burdens and the risk of loss associated with these assets.

Moreover, nothing in the Telecommunications Act triggers, or even permits, the *recognition* (much less the transfer) of any such gain. Under the Act, there is no sale of assets. There is no transfer of assets. To the contrary, the Act requires only that RBOCs reassign payphone assets on their books from regulated to unregulated activities. That reassignment, by settled Commission rule and Generally Accepted Accounting Principles, must take place at net book value. In addition, valuing these assets at "going concern value" is bad policy. The result will be an additional, time-consuming proceeding to establish a methodology and to choose among unauditable subjective estimates of value. Worse, the result is unlikely to help ratepayers, and ultimately will discourage investment and innovation in this industry.

I. "Going Concern" Valuation Would Be Unlawful

A. Going Concern Value is Inconsistent with Congress's Intent

There can be no dispute that the easiest and most straightforward way of handling the reassignment of payphone assets is to treat them at net book value. Under Section 276, this would trigger a reduction in RBOC price cap indices so that regulated rates no longer recover returns on these assets. The permanent reduction would be based on net book cost, since the rate base (upon which initial price cap levels depended) also was based on net book costs.

This is precisely the approach the Telecommunications Act of 1996 contemplates. Section 276 instructs the Commission to "discontinue the intrastate and interstate carrier access charge payphone service elements" and "all intrastate and interstate payphone subsidies . . . ." 47 U.S.C. § 276(b)(1)(B). To accomplish this, the Commission must identify the portions of these elements attributable to payphones, and eliminate any contributions -- which ultimately benefits ratepayers by reducing price cap indices. Nothing in Section 276 tells the Commission to go further and, *after* eliminating tangible assets from the rate base, force the RBOCs to purchase "appreciated" assets or non-book intangible assets from ratepayers. If Congress had intended such a dramatic departure from traditional practice -- which consistently excludes intangibles from valuation -- it would have authorized the Commission to promulgate regulations to achieve that effect. It did not.

B. Legal Precedent Precludes the Use of "Going Concern Value" Here

Nor does case law permit the Commission to use "going concern value" for this involuntary reassignment of assets. As an initial matter, transferring the appreciation in the value of RBOC assets from shareholders to ratepayers makes sense, if at all, only if the ratepayers somehow acquired an interest in the assets. But they did not. As the Supreme Court explained over 70 years ago:

> Customers pay for service, not the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stocks.

Board of Public Util. Comm'rs v. New York Tel. Co., 271 U.S. 23, 32 (1926). The logic is indisputable. If you go to McDonald's and buy a hamburger, you do not acquire an interest in McDonald's restaurant equipment, nor in the profits therefrom. Why should the result be any different when you buy phone service from Bell Atlantic?

Some have argued that the answer lies in Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir. 1973). According to the proponents of this approach, Democratic Central Committee effectively over-rules New York Telephone, and *requires* that all gains be allocated to ratepayers. But Democratic Central Committee says no such thing.

First, Democratic Central Committee on its face addresses only assets that appeared in the rate base and therefore produced compensation from ratepayers. It says absolutely *nothing* about assets -- such as "going concern value," contract rights, or goodwill -- that *never* have been part of the regulated rate base and have never produced regulated compensation. In fact, all of the rationales given for allocating some portion of appreciation to ratepayers in that case -- that ratepayers (in one instance) effectively contributed to capital, and that (in others) ratepayers bore risk on the property by guaranteeing a rate of return on it and paying for its depreciation -- have no application whatsoever to assets that have never appeared in the rate base or on regulated books.

In fact, the Democratic Central Committee court expressly limited its holding to "the circumstances *peculiar* to Transit as a public utility." 485 F.2d at 788 (emphasis added). Those "circumstances" were peculiar indeed -- and bear no relationship to those present here. The assets in Democratic Central Committee not only had formed part of the rate base but also were effectively purchased with *ratepayer capital contributions*. There, the cost of converting the utility from a mixed street-car bus system to an all-bus system was paid for not by capital contributions from investors -- who had acquired the company below market value and below book value[1] -- but by ratepayers. In fact, the public utility commission established a specific ratepayer-financed fund to pay conversion costs, and ratepayer contributions to this fund nearly equalled the total capital investment of shareholders. Id. at 812-13.[2] After the ratepayers invested this money in the conversion, the utility discovered that the conversion had freed up properties formerly dedicated to offering street-car service. The utility sought to sell those at a gain, and pass that gain through to shareholders.

Under those circumstances -- where ratepayers made the equivalent of capital contributions to permit the retirement of the assets -- the Court of Appeals held that ratepayers were entitled to a portion of profits from the assets' sale. See id. at 814 ("[B]ecause these properties were unsuited to the Transit's all-bus operation, the conversion rendered them surplus to Transit's needs. And, lest we forget, the financial burden of the conversion was, in its entirety, placed upon those who rode Transit's vehicles."). As the court summarized: "[T]he *crowning consideration* is the incontrovertible fact that the conversion, at full cost to the farepayers, was the *sine qua non* to release of valuable real properties from operating roles in the transportation scheme for uses in non-transportation ventures." Id. at 816. There can be no doubt that, as to the non-depreciable assets at issue there, the ratepayer capital contribution was the over-riding consideration; indeed, the holding hinged on whether the assets were related to the ratepayer-financed conversion. The court explained: *If* "the disposition 'was occasioned, in whole or in part, by' the conversion program" that ratepayers financed, *then* ratepayers are "entitled to a fair share of such profits." Id. at 818.

Here, the reassignment of payphone assets has not been "occasioned, in whole or in part," by anything the ratepayers have financed. Moreover, the assets at issue here -- the intangibles that make up "going concern value" but do not appear in fair market or net book value -- have not been paid for by ratepayers through depreciation. And they have not even

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[1]Id. at 814 ("We know that the price of Capital's road and equipment was some $10 million less than book value, and we cannot approximate how much less than fair market value at the time of acquisition the total price for all assets may have been.").

[2]Although the investors purchased the utility for about $13 million, the ratepayers contributed $10 million to the conversion. Ibid.

been a part of the basis on which ratepayers paid a rate of return. As a result, there can be no claim by ratepayers to their value. The cases recognizing this principle -- an important limit on Democratic Central Committee -- are legion.[3]

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[3]In fact, agencies that disregard this limit on Democratic Central Committee are regularly reversed on appeal. For example, in Philadelphia Suburban Water Co. v. Pennsylvania Pub. Util. Comm'n, 427 A.2d 1244, 1247 (Pa. Commw. Ct. 1981), the court reversed a public utility commission's decision to rely on Democratic Central Committee because, unlike the situation in Democratic Central Committee, ratepayers had not made the equivalent of an equity contribution. Moreover, the court explained, the ratepayers had not assumed the risk or the burden associated with the asset (land), as the land (like the intangible assets at issue here) was neither depreciated nor consumed. Id. at 1247-48. Case after case follows precisely the same course. See, e.g., Boise Water Corp. v. Idaho Pub. Utils. Comm'n, 578 P.2d 1089, 1093 (Idaho 1978) (Reversing agency reliance on Democratic Central Committee, explaining: "In that case the ratepayers were providing the capital by which the utility financed the acquisition of real property and other capital expenditures. In view of the fact that the utility's customers were providing the capital, in contrast to the usual situation where the capital is provided by the utility's shareholders, that court applied a rule which it styled 'the benefit follows the burden.' . . . We hold that the facts present in [the Democratic Central Committee case] do not exist here. [Consequently,] [t]he record is devoid of any justification for applying the benefit of the appreciation in value of the Hull's Gulch land to ratepayers rather than to shareholders." (internal citation omitted)); Lexington v. Lexington Water Co., 458 S.W.2d 778, 779 (Ky. Ct. App. 1970) (affirming reversal of PUC decision: "Having contributed nothing to its acquisition and having acquired no interest therein, the ratepayers assumed no risk in its disposition whether it be profit or loss."); Kansas Power and Light Co. v. State Corp. Comm'n, 620 P.2d 329, 340 (Kan. Ct. App. 1980) ("The situation [in Democratic Central Committee] can fairly be described as 'unique' in the sense that the ratepayers were in essence the source of the investment funds."); Washington Public Interest Org. v. Pub. Serv. Comm'n, 446 A.2d 28, 28, 31-32 (D.C. 1982) (affirming allocation of gains to shareholders where land was not depreciated and shareholders provided no capital); Maine Water Co. v. Pub. Utils. Comm'n, 482 A.2d 443, 448-49 (Me. 1984) ("The Commission's heavy -- and almost exclusive -- reliance upon the out-of-the-ordinary case of Democratic Central Committee . . . is misplaced . . . . [There] rate-payers paid for the acquisition of capital assets, a function usually performed by shareholders." (internal quotation marks omitted)); see also In re: Kansas City Power and Light Co., 75 PUR4th 1, 27-29, 1986 Mo. PSC Lexis 32, *59-61 (1986) ("In reaching its decision the [Democratic Central Committee] Court relied heavily on the fact that the property in question was tied to an upgrade program which was heavily burdening the ratepayers. . . . The argument for passing through the profit to the ratepayer is less persuasive in the case of nondepreciable property"); Order Instituting Rulemaking, 32 C.P.U.C.2d 233, 1989 Cal. PUC LEXIS 587, 104 P.U.R.4th 157 ("[F]or sales of utility assets . . . any gain on the sale should accrue to the utility shareholders, provided that the ratepayers have not contributed to capital and any adverse effects on the selling utility's remaining ratepayers are fully mitigated.").

Second, in Democratic Central Committee, there was a clear and voluntary realization event from which the gain could be recognized; the utility had chosen to sell the assets. Here, there is no sale, no transfer of assets, and no market transaction. Consequently, there is no recognizable "gain" that can be allocated to ratepayers -- and artificially requiring recognition would violate the Commission's rules and Generally Accepted Accounting Principles. In addition, because there was an actual market transaction in Democratic Central Committee, the market price of the assets was easily verified. Here, in contrast, the Commission would have to embroil itself in the difficult and inherently uncertain task of estimating "going concern value," an enterprise the Commission is ill-equipped to handle. Finally, unlike the transaction in Democratic Central Committee, the reassignment of assets here is involuntary rather than voluntary, so there can be no allegation of strategic asset selection.

Third, even if Democratic Central Committee can be looked upon as governing precedent, that case *never* held that the entirety of asset appreciation is always allocable to ratepayers. It held that, even in the "peculiar" circumstance where ratepayers have made the equivalent of a capital contribution, the utility's "farepayers are entitled" only to "a fair share" of profits. 485 F.2d at 818. The determination of what constitutes a "fair share," according to the court, depends on an analysis of the allocation of risks and burdens between shareholders and ratepayers. As explained in detail in the next section, the risks and burdens here have fallen on shareholders. Consequently, under Democratic Central Committee and any sensible notion of equity, the shareholders and not ratepayers are entitled to any benefits of asset appreciation -- and must bear the risk of asset devaluation.

II. "Going Concern" Valuation Would Be Unlawful and Inequitable

In Democratic Central Committee, the court held that the allocation of the right to profits was to be determined by two equitable principles: "One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom." 485 F.2d at 806. Under both of those factors, any value attributable to contracts and other intangible assets are properly allocated to shareholders, not ratepayers.

Risks. In Democratic Central Committee, the investors bore *no risk* at all. As the court explained, "there has never been any risk of financial loss, actual or foreseeable, on the parcels of land which concern us here." 485 F.2d at 811. No such thing can be said about the assets before the Commission in this proceeding. To the contrary, all of the RBOCs have been under price caps for interstate services for half a decade now. As a result, all of the business risks associated with holding payphone assets are borne by shareholders. If increased competition causes payphone income to fall, the shareholders earn a lower rate of return. If equipment becomes obsolete prematurely, the equipment is written off and shareholders must finance its replacement.[4] And, if the RBOC suffers a casualty loss, the cost of replacement must be borne by the shareholders or the RBOC's insurers.[5]

More important still, the debate here really is *not* about the value of physical payphone assets on RBOC books. If physical assets alone are valued, net book value is likely to exceed fair market value (because of inadequate depreciation, among other things). Instead, the debate centers on whether to include in the valuation assets that never have been, and never will be, on the RBOC books -- the value of intangibles such as "contracts" with location providers and goodwill. It is incontrovertible that the risk of loss on *these* supposed "assets" was borne exclusively by the RBOCs and not at all by the ratepayers. If the contracts had dried up because of increased competition, for example, the RBOCs could not have sought an exogenous price adjustment to make up the loss, especially since the "lost" assets never appeared on the RBOC's books.[6] And, critically, if the assets turned out to be perfectly

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[4]In its recent interconnection order, the Commission held that prices for interconnection and unbundled elements are to be based on the forward looking costs of "the most efficient telecommunications technology currently available," without regard to the embedded costs of the network equipment actually deployed by the incumbent LEC. First Report and Order, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Dkt. No. 96-98, FCC No. 96-325, at B-30 (rel. Aug. 8, 1996) (to be codified at 47 C.F.R. § 51.505(b)(1)). It is clear, then, that shareholders bear all of the risks of owning network equipment.

[5]Sharing is irrelevant because almost all of the RBOCs have chosen the no sharing option, which has no low-end earnings back-stop. Moreover, it is highly doubtful that the payphone business -- which represents less than 1 percent of RBOC assets -- would ever push the RBOCs into the low-end sharing range. To the contrary, almost all of the daily business risks associated with the enterprise, including losses to competitors, have in the past come out of shareholder profits, as they will in the future.

[6]Some might argue that an RBOC could make up losses by juggling prices within a basket -- lowering prices on the service that is no longer in demand and increasing prices on other, monopoly services in the same basket. But this strategy could only work if the "loss" took the form of decreased demand for a service that is sold separately, such that the RBOC could lower price on the service without suffering great losses, while increasing the price on a service with unaffected demand. Losses associated with the intangible assets the Commission seeks to value, such as the loss of contracts with location providers, does not reduce demand for a specific service subject to price caps. As a result, there is no service for which RBOCs could costlessly "lower" prices so as to permit a corresponding price increase in another service. RBOCs thus have no ability to adjust *any* price cap rate to offset such losses.

Even as to other services, a "carrier's ability to offset price decreases in some services with increases in others is restricted by the grouping of services into baskets and, within baskets, into service categories." Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, Telephone Company-Cable Television Crossvalueless today -- despite a large net-book value -- the Commission would *not* raise RBOC price cap indices to compensate them for their unrecovered investment. Consequently, it cannot be argued that ratepayers financed these "assets" or bore risk on them. This, standing alone, requires that appreciation in the value of the assets be allocated to shareholders.[7]

Burdens. The question of burdens need not detain us long. There is no evidence in the record, and nothing to suggest, that RBOC payphones have been financed by capital contributions from ratepayers. Contrast 485 F.2d at 812-15 (detailing the capital contributions made by ratepayers, which were applied toward retiring the properties to be sold at a profit). To the contrary, the ratepayers have paid a fair return at most on the actual physical assets themselves, i.e., the payphones; those assets are believed to be worth no more than net book value (as Arthur Andersen indicates in its study). The assets at issue here -- intangible assets that are reflected only in a going concern valuation -- have never been part of the rate base and therefore have never been financed in any conceivable way by ratepayers. If "the benefit follows the burden," then any benefit here belongs to shareholders.[8]

Ownership Rules, Sections 63.54-63.58 and Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, 10 FCC Rcd 244, 318 (1994). The Commission groups substitutable services into the same basket according to an evaluation of the degree of competition faced by those services, ensuring that a BOC "will not raise prices for services for which it retains substantial market power and use revenues generated thereby to fund price decreases for other, more competitive services." Report and Order and Second Notice of Proposed Rulemaking, Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 2897 (1989). Thus, increased competition and other business risks associated with one service do not permit the RBOCs to raise prices on other services in the same basket, as all in-basket services have the same degree of competition -- and roughly the same price elasticity of demand. And, if the argument is that RBOCs could raise prices to make up losses because they already are pricing below the caps, the RBOCs have the same incentive to raise prices and maximize revenues whether or not there are losses to offset.

[7]In AT&T Information Systems v. FCC, 854 F.2d 1442, 1447 (1988), the D.C. Circuit clarified that, at least with respect to depreciable assets, the "risk of loss" analysis is paramount; only if the risk of loss principle proves inapplicable should the FCC look to the secondary question of burden. See also id. at 1444.

[8]Even as to depreciable assets that appeared on RBOC books, it is questionable whether the Commission could force gains to be allocated to ratepayers. First, there would be no appreciation to recognize, as the Commission's depreciation rates are, if anything, too stingy rather than too generous. Second, any rule allowing shareholders to recover "excess" depreciation would violate the rule against retroactive ratemaking. In essence, the Commission would be (improperly) holding that ratepayers paid too much for the use of the assets (they did not depreciate as much as anticipated), and that shareholders therefore should somehow be forced to refund the "overpayment."

Advantages. In addition to addressing the risks and burdens associated with the assets, the court in Democratic Central Committee also addressed to whom the "advantages" associated with the assets had accrued in the past. In particular, the court noted that the shareholders had acquired the properties "at an excellent bargain" -- below market price and below net book value -- and had gone on to earn "an actual paid out return of 830 percent on original equity" during the first decade of ownership. 485 F.2d at 815. If the RBOCs had earned 830 percent on their payphone investments over the last decade, the Commission might conceivably argue that they had profited too much already. But payphones on the whole have been money-losers, and shareholders have hardly earned exorbitant returns on them in the past. Indeed, the RBOCs on the whole have earned *less* than the regulated rate-of-return on payphones and -- because that loss comes out of shareholder dividends under price caps -- they have suffered a *disadvantage* rather than having derived an advantage.

Thus, both legal precedent and equitable considerations preclude forcing the RBOCs to pay ratepayers for assets that, like "going concern value," have never been part of the rate base, and for which ratepayers never bore any risk. And, as explained in greater detail below, doing so would be contrary to Commission precedent and rules in myriad ways.

III. "Going Concern" Valuation Would Be Contrary to the Commission's Rules and Proper Accounting Treatment

A. The Commission's Rules Do Not Allow for "Going Concern Valuation"

As the Commission recognized in its NPRM, the Telecommunications Act of 1996 does not require the RBOCs to divest themselves of their payphone operations or to operate them as separate affiliates. Consequently, no "transfer" or sale of assets need take place. The only thing that occurs is a reassignment of assets from regulated to non-regulated activities on RBOC books. Because Part 64 of the Commission's rules provides for allocation of Part 32 costs among regulated and non-regulated activities (based on "direct" or "causative" allocation formulae), the assignment or allocation to Part 32 accounts must be at net book value. See 47 C.F.R. § 64.901(a), (b)(2); id. § 32.2000(b)(2)(ii), (iii).

Nor do the Commission's rules allow for use of "going concern value" where an RBOC chooses to operate non-regulated activities through a separate affiliate. The Commission's rules instead provide that assets transferred to an affiliate are valued at the higher of net book value or "fair market value." 47 C.F.R. § 32.27(c). "Fair market value" never has been equated with "going concern value." To the contrary, "fair market value" looks to the price the market would pay, or the RBOC would pay the market, for the tangible assets transferred off the RBOC's books; it has never been interpreted to include the value of unidentified intangibles (like reputation, employee skills, contract rights) captured under the rubric of "going concern value." See Order on Reconsideration, Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, 2 FCC Rcd 6283, 6296 (1987) (rejecting an expansion of "fair market value" beyond "tariff rate or price list" because it "would greatly expand the complexity of auditing affiliate transactions" and force companies to "bring subjective judgment to bear") ("Joint Cost Reconsideration Order").

B. The Commission's Rules Prohibit the Assignment of Value to Intangibles that Do Not Appear on RBOC Books

In fact, the Commission's rules and practice consistently exclude the value of "intangibles." For example, in the Commission's Joint Cost Reconsideration Order, 2 FCC Rcd at 6315-16 n.204, the Commission rejected a recommendation that a non-regulated affiliate be charged for the training of an employee that had been transferred to it. As the Commission explained, because employee training is "an intangible benefit" and a "sunk" cost, the value thereof is of no consequence under the Commission's rules.[9]

The Commission again rejected valuation of intangibles when reviewing RBOC cost allocation manuals. As it explained in approving Ameritech's refusal to allocate the value of its "name":

> In the *Joint Cost Order*, the Commission found that intangible benefits, and the allocation of those benefits, was beyond the scope of this proceeding. [Citation omitted]. Although the *Joint Cost Order* provides a mechanism for allocating all of a carrier's costs between regulated and nonregulated activities, intangible benefits, such as the Bell name, are not costs. No cost associated with the Bell name has ever appeared on Ameritech's books.

Memorandum Opinion and Order, Ameritech Operating Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Non-regulated Costs, 3 FCC Rcd 433, 437 (1988).[10]

Similarly, in 47 C.F.R. § 65.450(c), the Commission specifically addresses the treatment of "assets" that do not appear as "costs" on RBOC books, and it specifies that they are *not* to be valued or assessed even when a transaction does takes place: "Gains or losses related to the disposition of property that was never included in the rate base shall not be considered for ratemaking purposes."

These decisions -- and this rule -- are dispositive. The push behind a "going concern" valuation is to force RBOCs to recognize a fictitious "gain" based on the value of intangible assets, like contract rights and other elements of "goodwill," and then allocate that fictional

[9]In contrast, the provision of employee training services might be the provision of a service subject to cost allocation rules.

[10]The Commission also used net book value in a proceeding indistinguishable from this one. In deciding that inmate payphones should be reclassified as CPE, the Commission required that the payphones be transferred at net book value. See Declaratory Ruling, Petition for Declaratory Ruling by the Inmate Calling Services Providers Task Force, 11 FCC Rcd 7362, RM Dkt. No. 8181, at 13, ¶ 27 (rel. Feb. 20, 1996). No distinction can be made between that proceeding and this one.

"gain" to ratepayers. But none of those assets are "costs," and none ever appeared as such on RBOC books. Accordingly, the Commission's own rules preclude their consideration in establishing RBOC asset valuation and rates.

C. Generally Accepted Accounting Principles Bar the Commission from Forcing Recognition of a Gain

Unsurprisingly, proper application of Generally Accepted Accounting Principles ("GAAP") yields precisely the same result. As Arthur Andersen has pointed out, Accounting Principles Board Opinion No. 16, Business Combinations, Accounting Interpretation No. 39, Transfers and Exchanges Between Companies Under Common Control, requires that transfers of assets between entities under common control be "accounted for at historical cost . . . ." See Arthur Andersen, Calculation of Per-Call Compensation and Review of Accounting and Regulatory Treatment for Payphone Asset Reclassification, July 1, 1996, at 19 (attached to the Comments of the RBOC Payphone Coalition).

Requiring the recognition of a "gain" on intangibles upon reassignment of the assets (whether they are reassigned to unregulated activities or to an unregulated affiliate) is utterly inconsistent with this rule. Since no cognizable realization event occurs, GAAP requires reassignment based on net book value. The Commission, having committed itself to GAAP principles, is not free to disregard this sensible rule.[11] Moreover, disregarding the requirement of a realization event introduces great uncertainties, the potential for grave unfairness, and tremendous costs: Without an actual market transaction, it is virtually impossible to place a "going concern value" on assets like these.

D. No "Pass-Through" of Unrealized Gains on Intangible, Non-Book "Assets" is Permitted Under the Commission's Rules

Finally, even if the Commission were to disregard its rules and force recognition of a gain, there would be no benefit in it for ratepayers. To the contrary, the Commission's rules preclude any effort to shift such a phantom gain to ratepayers.

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[11]As the Commission has held, "the USOA has been designed to reflect stable, recurring financial data based to the extent regulatory considerations permit upon the consistency of the well established body of accounting theories and principles commonly referred to as generally accepted accounting principles." 47 C.F.R. § 32.1. See also 47 C.F.R. § 32.12(a) ("The company's financial records shall be kept in accordance with generally accepted accounting principles to the extent permitted by this system of accounts"); id. § 32.16 (a) ("The company's records and accounts shall be adjusted to apply new accounting standards prescribed by the Financial Accounting Standards Board or successor authoritative accounting standard-setting groups, in a manner consistent with generally accepted accounting principles."). Had Congress wished the Commission to part company with GAAP and require the recognition of gains on intangible assets even where no realization event takes place, it would have so specified in the Telecommunications Act.

The Effect of a Gain. Some may believe that forcing the RBOCs to recognize a "gain" -- despite the absence of a realization event -- will inflate their earnings and result in rate reductions for consumers in later years. The flaw behind this theory is that almost all of the RBOCs have elected the no-sharing option under price caps. Thus, just as a loss on this business will not increase rates, so too a gain will not decrease them.

Exogenous Treatment. It also has been suggested that the Commission might force the RBOCs to recognize a gain and then treat that gain "exogenously" to reduce future rates. But there is no such thing as exogenous "profit" adjustments, only exogenous "cost" adjustments. Moreover, in its Price Cap Performance Review Order, the Commission announced that exogenous cost treatment is not appropriate for "non-economic" accounting changes, which it defined as accounting changes that do not have an affect on cash flow. See First Report and Order, Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, 9095 (1995). The forced "recognition" of an unrealized "gain" is precisely the sort of non-economic, accounting event that cannot be treated as exogenous under this rule.[12]

Nor could the Commission require RBOCs to reduce their price cap indices ("PCIs") *permanently* by adjusting them downward based on a going concern valuation (rather than net book value). Such an approach would remove from the rate base the value of assets (intangibles or appreciation) that *never* appeared in the rate base in the first place. The result would be not only unfair but also irrational: Such an approach, if taken to its logical extreme, would result in negative prices for telephone service and confiscation of shareholder assets.[13] The approach is also contrary to the statute, which calls for the elimination of subsidies, not the elimination of payments that do not constitute and could not conceivably constitute subsidies.

Requiring a permanent PCI adjustment based on "going concern value" is irrational from another perspective as well. A one-time, temporary reduction in PCIs based on "going concern value" effectively forces the shareholders to "purchase" the asset from ratepayers through rate reductions once. A permanent reduction in the same amount effectively requires the shareholders to "purchase" the asset from ratepayers at the "going concern value" once a

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[12]Moreover, if the Commission were to treat the "reduction" in costs that comes with asset reassignment exogenously, it would have to treat the "increase" in costs that comes from gain realization exogenously as well. The result would be, on the whole, the same as simply reassigning the assets at net book value.

[13]Consider the example of an RBOC that establishes price caps on the basis of assets valued at $1. Suppose also that those assets triple in value to $3, and the RBOC is forced to reassign $2 worth (measured by "going concern value") to unregulated activities. If a permanent reduction in PCIs is based on the "going concern" value of $2, the RBOC would reset its prices based on an asset value of negative $1 -- the $1 of assets on the books, minus the $2 going concern value for the reassigned assets, leaves a residual value of negative $1.

year -- year, after year, after year. Calling such a result arbitrary and capricious is a gross understatement.

Non-book, Intangible Assets. In any event, the Commission's own rules *prohibit* the Commission from considering, for ratemaking purposes, gains on assets that never appeared in the rate base. See 47 C.F.R. § 65.450(c) ("Gains or losses related to the disposition of property that was never included in the rate base shall not be considered for ratemaking purposes."). This is a sound rule. If the ratepayers never saw the asset on the books, they neither paid a rate of return on it nor bore risk for it. Accordingly, their rates should not be influenced by it either.

IV. "Going Concern" Valuation Would Be Unadministrable

In addition to recognizing the legal obstacles to the use of "going concern value," the Commission should recognize the practical difficulties as well. For one thing, the contours of any "going concern" methodology will have to be specified, probably in yet another proceeding; and then the Commission will have to implement it. The result inevitably will be delayed implementation, even though Congress allocated just nine months for the rule promulgation process.

Moreover, any such methodology will prove complex and involve innumerable variables -- not to mention the exercise of unauditable, subjective judgment. Individual phones and contracts will have to be evaluated for cash generation and cost, often without any adequate basis for comparison.[14] Assumptions will have to be made regarding future income streams, the proper risk factor for contract non-renewal, changes in the regulatory environment, and estimated losses because of increasing competition. Each of these assumptions will be hotly contested, and any attempt to resolve them is likely outside the Commission's area expertise. Finally, the result will have to be implemented on a jurisdictionally separated basis, adding yet another layer of complexity.

Confronted with these very concerns once before, the Commission determined the flame was simply not worth the candle. When the Commission transferred AT&T's CPE to ATTIS at divestiture, AT&T argued that fair market value was *less than* net book. It therefore urged the Commission to use fair market value rather than net book. (The Coalition can make the very same argument but has opted for net book as administratively easier). The Commission, however, rejected that approach. See Report and Order, Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), 95 F.C.C. 2d 1276, 1306 (1983). There, as here, the costs of appraising the assets were too great. Id. at 1307. There, as here, time pressures were great, and there was no

[14]The Commission cannot simply choose a value per deployed payphone; RBOC payphones are on average worth less than non-RBOC PSP phones -- many are worth nothing or have negative values because operating costs equal or exceed limited revenue streams -- and per payphone value varies from phone to phone and region to region.

guarantee that an economic valuation could be accomplished before the deadline. Id. at 1306. And there, as here, "there was no assurance that appraisals would yield any precise results regarding economic value because transfers of this type, and on this scale, have never before been undertaken." Id. at 1307. Accordingly, the Commission concluded that net book value was a reasonable proxy for economic value, id. at 1310, and the D.C. Circuit agreed. See AT&T Information Systems, 854 F.2d at 1446 ("The FCC's decision to use net book value . . . provided an acceptable -- and accepted -- basis for the detariffing process."). The same factors lead to the same conclusions in this proceeding.

Moreover, even if the Commission were to invest the innumerable man-hours required to conduct a going concern valuation and resolve the disputes arising therefrom, there is no reason to believe the result will exceed net book value. Most payphones have been under-depreciated, and the RBOCs have many payphones that are liabilities rather than assets. Although these payphones run at a loss, regulators have resisted their removal. Consequently, it is far from clear that, even if the Commission were to go through the effort of conducting appraisals of all RBOC payphones -- and to take a machete to its rules and settled practices in the process -- the result would vary from net book value. The Commission so concluded when it dealt with the CPE in the ATTIS order, 95 F.C.C. 2d at 1310, and there is no reason reach a different conclusion here.

V. "Going Concern" Valuation Would Be Bad Policy

Finally, the Commission cannot defend the use of a "going concern value" on the basis of policy. Such a decision sends a clear message to investors: Although investors may bear the risk, all returns will be given to ratepayers (regardless of what the rules may say). The result is less investment, less innovation, and lower quality services.

Indeed, an artificially high valuation could simply lead the RBOCs to exit this business rather than undertaking what amounts to a forced "purchase" of their own assets at an inflated price. Given the difficulty of choosing a single discount rate applicable to all the RBOCs -- particularly given their different overall business strategies -- this is a very real possibility with significant potential consequences for the maintenance and deployment of payphones. Consumers would be deprived of RBOC participation in a market in which they traditionally serve areas that otherwise would not be served. Congress directed the Commission to deregulate the RBOCs' payphone units, not to force their divestiture.

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